International Updates

Pension Reform: New Model Implemented in Croatia and Poland

Croatia and Poland are making changes to their pension systems that are crucial to their developing and changing economies. Both countries are changing from a planned economy to a market economy, and both must deal with the aging crisis facing many developed countries.

The post-war regime had moved toward a system where pension benefits were an integral component of a full-employment policy. Workers were paid wages within a highly compressed band that did not much reflect the economic value of their work during "normal" working age (which usually ended quite early as compared with systems in the West). The level of benefits was more weakly linked to past earnings than in the West, in part, because credits were given for years spent outside the labor force for persons engaged in such activities as child care and secondary education. Pension benefits tended to favor women, short-term workers, and low earners more than men, career workers, and higher earners (though the latter still tended to have somewhat larger pensions). Because inflation officially was not characteristic of socialist economies, payments were rarely indexed.

This characteristic state-socialist structure faced three major problems as the transition began.

(1) Labor laws overburdened the wage system by loading it with social protection features that could not be accommodated in a competitive market-based economy.

(2) The social security system, designed to support the entire population not in the labor force, was overburdened.

(3) Alternative social assistance mechanisms (other programs, the family, or tax provisions) that might serve the same function were absent, undercut by social policy, or underdeveloped.

Even in the 1980s, these systems faced considerable problems because of sharply declining birthrates and low-productivity growth, but difficulties increased greatly during the past decade with the transition from a planned economy to a market economy. The need to reduce large numbers of workers from economically nonviable firms often led to accelerated retirements and increasing awards of disability. This had the financially difficult consequence of increasing the ratio of beneficiaries to contributing workers.

While the need for reform was obvious at the beginning of this decade, models for change were not so clear. The developed free-market economies were, for the most part, experiencing problems with their own pension systems and were also searching for alternative models, including privatization, multiple benefit tiers, and personal accounts. These models offered reformers many possibilities, and several countries have taken quite different paths. Perhaps the most influential model has been the one formulated by the World Bank (an important source of funds and advice during the transition). This model rests the system on three "pillars":

- Pillar 1: a modest mandatory pay-as-you-go public floor;
- Pillar 2: a fully funded defined-contribution personal or occupational pension; and
- Pillar 3: supplementary voluntary savings.

The underlying rationale rests on the contradictory nature of the problems facing society and the individual, and the solutions available. Providing a social safety net undercuts incentives for private effort and savings and makes the individual more dependent on the state; empowering individuals puts the less advantaged members of society at risk. A multi-pillar system, by combining the advantages of each approach while offsetting its weaknesses, offers a set of trade-offs, which some policy makers are considering.

Croatia

Background.-Croatia is the second richest of the former Republics of Yugoslavia. In 1996, the country had a per capita gross national product of US$3,830 and one of the more open economies in central Europe. Croatia's population is about 4.8 million, with a comparatively well-educated labor force of about 1.7 million employed in an industrial market economy; import and export of goods and services account for approximately 95 percent of gross domestic product. It is against this backdrop that the new pension scheme was introduced.

Pension Scheme.-The World Bank is providing Croatia financial backing for transforming the current pay-as-you-go system into a three-tier partially funded one. The Welfare Minister recently noted that reform of the pension system needed to be undertaken as soon as possible. At present, it consists of only one compulsory pension scheme. However, in November 1996, a three-tier system was introduced, which will be implemented in January 1999.

The new system comprises two compulsory pillars and one voluntary insurance pillar. The total amount set for compulsory contributions under the new system will be the same as under the old, but there will be a *redistribution* of contributions between the first and second compulsory pillars. The latter will consist of a fully funded defined-contribution scheme based on individual accounts; it will cover only those persons less than age 40, while those older will receive pensions from the existing scheme only. Persons younger than age 40 who have already acquired pension rights from the current scheme will receive both a pension from that scheme and a basic pension for the period after they joined the second pillar.

Financing.-Under the outgoing system, contributions are split evenly between employers and employees, each paying 12.7 percent. Under the new system, contributions (though reallocated) will continue at the present rate and will still be split evenly between employer and employee. The state budget will cover the deficit resulting from the shift of one-half of contributions from the basic scheme to the second compulsory private pension tier. The third tier is voluntary and will not receive state funds.

Retirement age.-The retirement age, at present, is 60 for men and 55 for women (with 20 years of coverage); ages 65 and 60 (with 15 years of coverage); or any age for men and women with 40 and 35 years of insurance coverage, respectively. Under the new legislation, effective January 1999, the retirement age will be increased to 65 for both men and women over a 5-year period. The age requirement for early retirement pensions will experience a comparable rise-from today's age 55 for men and 50 for women to ages 60 and 55, respectively. Finally, the pension reduction for early retirement will rise from 1.33 percent per year to 3.6 percent.

Retirement benefits.-Under the new scheme in Croatia, the basic pillar will pay a maximum old-age pension of 32 percent of national average earnings after 40 years of coverage. (The old pension system pays from 35 percent to 85 percent of average earnings in the best 10 consecutive years.) The second pillar, a fully funded defined-contribution scheme based on individual accounts, will provide additional benefits, as will the third benefit pillar based on voluntary insurance provisions.

Survivor benefits.-The age of eligibility for a widow(er) benefit is presently set at 60 but will be lowered to age 50. Pensions will be paid at 70 percent to 100 percent of a full retirement pension. Anyone receiving a pension who becomes widowed will be entitled both to that pension in full and 30 percent of the deceased spouse's pension as well.

Disability benefits.-The new scheme tightens eligibility requirements for benefits in various areas of disability coverage. Full pensions will be provided only in cases of disability caused by work accident or occupational disease. For other disabilities, pensions will be paid at a lower level (66.7 percent of pay, compared with 100 percent pensions for work-related injury). Persons with disabilities who are able to find other employment will continue receiving a disability pension equal to one-half of these respective amounts.

Administration offinds.-A tripartite public Pension Insurance Institution will be established. In place of government management, the funds will be the joint responsibility of three corporative groups: (1) the government trade union, (2) employer unions, and (3) beneficiary unions. The Pension Insurance Act provides for an equivalent of a month's pension expenditures to be maintained for the protection of employees.

Poland

Background.-In the early 1990s, Poland was the first central European country to embrace bold policies of economic reform toward a market economy. After serious economic difficulties during the years 1989-9 1, it has experienced encouraging growth, with gross domestic product reaching 7 percent in 1995, faster than any other large European country. In that year, it had a per capita income of about US$2,270 and a population of 38.5 million.

However, these economic successes notwithstanding, Poland's liabilities were substantial. Social security expenditures were becoming increasingly burdensome. Though there was relatively little decline in the number of contributors, the number of pensioners and (unusual for central Europe during the transition) the size of replacement rates both rose considerably. The first factor, especially, is due to increases in the award of disability benefits; the consequence of the second is that Poland's benefits are among the most generous (relative to average wage) in central Europe. Both are probably due, in part, to the particular circumstances of Poland's transition. Unlike most other countries, the change of regime was led by the labor movement and this has worked to maintain policies that were welfare-oriented and emphasized social solidarity.

Low labor costs made Poland initially attractive to multinational firms seeking locations for new facilities. That attractiveness, however, diminished in a country where employer-financed social security had risen from 25 percent in 198 1 to 45 percent in 1995.

In 1996, Poland created the Office of the Government Plenipotentiary for Social Security Reform and, with that action, the reform process began in earnest along the lines recommended by the World Bank. On September 16, 1997, the President of Poland signed legislation that provided for the creation and operation of private pension funds. Poland's refonned state and mandatory private system will be in place by early 1999. The government, which this year is launching a program of privatization of state companies, will use part of the proceeds to help finance social security.

Pension Scheme.-The existing system is being scaled back to provide a basic level of protection, though the shortfall of pension funds due to the diversion of contributions to the new second pillar will be partially filled by the state and state-owned companies. New mandatory funds managed by private "pension fund societies" will provide a second pillar that supplements the existing pay-as-you-go social security system. A third pillar will also be made available in the form of voluntary pension savings.

Persons under age 30 will be required to join the new funds. Employees aged 30-49 will have the option of remaining in the current system or participating in the new funds. Employees aged 50 or older, or those who meet the requirements of early out, will not be affected by the reform.

Financing.-Contributions to the state system will be reduced for those who are required (or opt) to contribute to private funds, and ceilings will be placed on contribution levels. State benefits will be more closely linked to contributions, thereby reducing risk of evasion (which has proven to be a substantial problem). At present, the employee pays nothing, while the employer pays 45 percent of payroll (the self-employed pay 40 percent, while farmers, a sizeable group, contribute a flat amount). Under the new law, effective January 1999, the rate will be reduced over a 15-year period to 35 percent, and eventually to 30 percent. Contributions will be shared equally between employer and employee, according to a schedule set by regulations now being drafted. It is also anticipated that 20 percent of total contributions will be allocated to individual pension accounts.

Retirement age.-During the past several decades, the retirement age in Poland was uncharacteristically high for central Europe-65 for men with 25 years of insurance coverage and 60 for women with 20 years of coverage-though in practice, retirement ages averaged considerably less because of various widespread and fairly generous early retirement provisions. Under the new pension plan, the minimum retirement age for both men and women is 62. However, the legislation is designed to encourage persons to extend their working lives by providing that each additional year of work will increase pension benefits.

Retirement benefits.-It is estimated that approximately 60 percent of future pensions will come from the first pillar and 40 percent from the second. Pensions from the second-pillar mandatory funds will be paid on a defined-contribution basis only for o!d age; these funds will not provide disability benefits. A minimum pension will be set at about 28 percent of current average pay. Should the combined first- and second-pillar pensions be lower than this minimum, the difference will be covered by the state budget; it is expected that about 10 percent of pensioners will require this supplement.

There will be no role for the mandatory funds in the actual payment of pension benefits. At retirement, a dedicated pension annuity company of the member's choice will receive a transfer payment. The type of annuity purchased, the kinds of guarantees selected, and whether or not survivor benefits are included, will be at the member's option.

Survivor and Disability benefits.-As previously noted, the availability of survivor benefits will depend primarily on the annuity choice the insured person makes when retiring. However, pension fund assets may be inherited under certain conditions. Funds will not provide disability benefits, a responsibility retained by the state.

Administration of funds.—Pension societies-independent entities, authorized and supervised by the Pension Funds Supervisory Office-will manage two types of funds. The first is an *open fund,* simply a collection of assets held on behalf of members by an independent depository, such as a bank; the second, *a fund available only to participants aged 50 or older,* who would invest only in fixed-income securities. All asset management will be undertaken by the pension fund society, though the legislation mandates the appointment of a separate custodian.

A Pension Funds Supervisory Office will oversee the new system and will report directly to the Prime Minister. This supervisory office will be financed both by the state budget and by contributions from employers. The pension fund societies and pension funds that comprise the second pillar will be subject to strict licensing procedures. The government has established a relatively high minimum capital amount that it hopes will have the effect of limiting the number of funds from between 8 and 20. Funds will be required to develop separate reserve accounts. If these funds prove insufficient, pension society funds will be used or, as a last resort, assets of a central guarantee fund financed by a levy on pension funds will be used.

At the outset, each society may offer no more than one investment vehicle. The typical pension fund is expected to be a mixed one with investments that conform with specified asset allocation limits. In the year 2005, each society will also be required to offer another vehicle that invests only in securities with interest that is fixed (comparatively low-interest government bonds), available only to those aged 50 or older. Societies will then also be able to offer one or two other funds that are not age-restricted. They will be able to charge for administration, up to 0.6 percent of assets per anum, and also to collect commissions. Societies will maintain specified rates of return and, if necessary, use their own reserves to meet the required minimum yield.

The law provides for a clear separation of responsibilities. While the pension fund societies manage and invest assets, an approved depository bank or the National Securities Depository will assume custodial responsibilities. Under the new legislation, employers are also permitted to establish pension arrangements for their employees. While the details are not yet fully worked out, it is likely that employers will be able to establish their funds with the help of an independent organization, such as an insurance company.

Conclusion

The changes in the social security programs of Croatia and Poland represent significant moves away from the old pay-as-you-go pension plans. These new plans include components that allow employees to make independent choices about their own pension investments. The state-managed mandatory funds, however, will continue to provide significant monetary benefits and safety nets in the form of minimum guarantees and fund emergency reserves.

-Alexander Estrin and Corrinne Lennox

Sweden's Trust Fund Experience

Sweden's social insurance program, originating in the early 20th century, has undergone far-reaching developments, particularly in the post-World War II period. There are now two coordinated pension plans. The older of these, providing basic pensions, originated before World War I and was intended to guarantee basic security for everyone. In 1960, the national supplementary pension (ATP) scheme was introduced to guarantee a pension related to previous earned income. The ATP is entirely financed through social insurance contributions paid by employers and the self-employed.

In principle, the Swedish scheme has been a pay-as-you-go system, built on financing each year's pensions using current contributions. Despite the fact that the ATP is therefore basically a redistributive system, the Swedish Riksdag (parliament) built in a funding component for two reasons.

(1) A trust fund build-up would counteract the expected reduction in savings in the household sector.

(2) The fund would act as a buffer to deal with imbalances resulting from short-term fluctuations between incoming ATP contributions and outgoing pension payments.

Contributions are paid into a fund that now contains a reserve sufficient to cover some 5 years of pension payments. This update summarizes recent experience and developments with the management of the fund.

The AP Fund's Assignment

There are now six Pension Fund Boards that handle the reserve assets. The oldest three-AP Funds 1, 2, and 3-hold most of the balance and have invested only in bonds and real estate; the smaller and newer AP Funds—4, 5, and 6-have some experience in investing in equities, subject to clearly defined limits.

The Swedish Pension Fund Regulations Act, effective in 1960, established a number of guidelines for managing the Fund. It is to be administered in such a way as to:

- produce a high rate of return in the long term;
- ensure a satisfactory level of liquidity;
- spread investment risk; and
- achieve a high level of security.

This combination of requirements has led to investment being limited mainly to bonds and other interest-bearing securities. As a result, the requirements as to both liquidity and security are generally met, though perhaps with some limitation in the rate of return. The Riksdag has charged the AP Fund Boards with the task of managing the Fund with a view toward ensuring the largest possible contribution to the national supplementary pension scheme; in the spring of 1993, it amended the regulations to focus on maximizing overall return on assets in the long term.

Under the terms of the Act as currently amended, the Fund may invest freely in interest-bearing securities with the proviso that investments denominated in foreign currencies may not exceed 10 percent of the market value of total assets. A further restriction is that investments not classed as having a low credit risk may not exceed 5 percent of the market value of the total assets.

The 5 percent limit also applies to investments in property, both in Sweden and abroad. Opportunities for investing in equities until now have been limited to shares in property (real estate) companies, and even then only within the 5 percent property investment quota.

Small portions of the AP Fund have subsequently been assigned to the equity-oriented fourth, fifth, and sixth Fund Boards. These were set up in 1974, 1988, and 1996, respectively, and are allowed to invest in shares and other securities on capital markets. In December 1996, the newly created sixth Fund Board received the entire SEK 10 billion-about US$ 1.25 billion-that the Riksdag had decided should be transferred to the newer Boards from assets managed by the older first, second, and third Fund Boards.

Performance

The Fund Boards' goal-management of assets to maximize benefits to the ATP scheme-has been achieved with a wide margin to spare.

- Real return for 1996 was 14.9 percent and averaged 9.7 percent for the 5-year period 1992-96, considered very satisfactory given the restrictions on the forms of investment that apply.
- Of the Fund's managed assets, nominal fixed-income investments accounted for 87.6 percent; CPI-linked fixed-income investments, 8.9 percent; and property, 3.5 percent.
- Falling interest rates during 1996 led to a 4.9-percent increase in the market value of the Fund's fixed-income bond portfolio. Its total return was 14.8 percent.
- Falling interest rates during the year also led to a 12-percent increase in the market value of the Fund's CPI-linked fixed-income investments. Total return for these in 1996 was 16.3 percent.
- The value of the Fund's property portfolio has been reassessed and increased by 3.1 percent. Its total return for 1996 was 10 percent.
- The AP Fund had a return of 3 percent from the equity-investing fourth and fifth Fund Boards in 1996, totaling SEK 0.5 billion. During that year, these two Boards requisitioned a total of SEK 0.4 billion from the AP Fund.

The high overall rate of return has thus been achieved mainly from nominal fixed-income investments, but the Fund Boards have been striving to increase the index-linked element of its portfolio, making relatively large purchases of CPI-adjusted fixed-income bonds (whose value increased from SEK 8 billion to SEK 40 billion-US$l billion to $5 billion-during 1996). Further efforts in that direction are included in asset allocation plans for the next few years.

Return on property as an investment category during 1996 reflects initial investments in the form of indirect holdings in the United States in Real Estate Investment Trusts (REITs). These investments implement a decision that, where possible, international property assets should be held via shares or participation.

The increases in market value in the fixed-income investments that make up most of the portfolio resulted mostly from falling interest rates in Sweden during the year; in the near term, a rather conservative strategy has been quite profitable and, as can be seen, considerably surpassed the performance of the small fourth and fifth Board investments. However, this increase in the value of the Fund's bond portfolio cannot be realized in the short term except to a marginal extent, and such increases in value during one year are offset by decreases in another when interest rates rise again. In this context, it is important to bear in mind that the Fund's role is a long-term one. Making long-term decisions on the basis of performance during periods shorter than 5 years is considered unsafe.

While performance of the invested funds has not fallen short of expectations over the years, it has not been sufficient to offset other pressures that led to the new 1998 pension reform. Current shortfalls in the ATP scheme (the excess of benefits relative to contributions) reached SEK 33 billion (about US$4.2 billion) in 1996. These have resulted primarily from both slowdowns in payroll contributions and increases in benefit uptake, reflecting the serious labor market difficulties of the past decade.

This shortfall does not appear to be increasing at the same rate as before, partly due to increases in rates of pay resulting in higher contributions and partly as a result of measures taken to reduce outlays, but direct return on the Fund (interest, dividends, and realized capital gains) can no longer cover additional ATP costs. Moreover, it is expected that both inflation and interest rates will remain at relatively low levels, resulting in a fall from present direct returns over the next few years. Therefore, while the Fund has served its intended function as a short-term buffer against ATP operating imbalances, the underlying longer term problems exceed its present capacity. Some time can be expected to elapse before it becomes necessary to start dipping into the Fund's capital, but the old system appears to have insufficient funding in the long term.

A Partial Shift to Personal Trust Fund Accounts

The June 1998 reform bill provides that a small portion (2.5 percent of payroll) of contributions will be placed in mandatory "Premium Accounts." (This provision applies in full to those born after 1953, and on a lesser sliding scale to those born as early as 1938; anyone born prior to these years remains entirely in the old system). These accounts will be managed in the name of the individual earner and accessed at retirement or other appropriate occasions.

The public will be able to choose how they want the premium reserve to be invested; analysts expect most of these investments to go into private rather than state schemes. A "Public Pension Agency" will purchase fund shares in market funds (including foreign equities) on behalf of the individual participants. It will also be responsible for the daily business of processing orders for individuals who wish to switch funds, and for creating and providing information about the insurance products offered.

A conservatively managed public fund, invested in government bonds, will hold the funds of persons who do not indicate any other choices. Funds withheld from pay and forwarded by employers will be kept in an "interim fund" managed by the state Treasury until the individual's account amounts for the year have been established.

The Financial Supervisory Agency licenses and supervises market funds in the course of its normal business. It will also, together with the National Social Insurance Board, oversee the business of the new Public Pension Agency.

—Rita L. DiSimone